Structured Finance Group

Client Alert

Agencies Ease Volcker Rule Restrictions for CLOs

June 30, 2020

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On June 25, 2020, five federal regulatory agencies (the "**Agencies**")[1] released a final rule (the "**Modified Rule**") modifying and clarifying the Volcker Rule's prohibition on banking entities investing in or sponsoring covered funds. Although the significance of these changes will only become apparent with time as the market digests the new flexibility they offer, this alert summarizes a few preliminary take-aways for CLO industry participants.

BACKGROUND

The Volcker Rule was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the initial regulations implementing which were issued in December 2013 (the "**2013 Rules**"). The rule prohibits banking entities from having an "ownership interest" in and certain relationships with any "covered fund", which it generally defined to include any entity that would be an "investment company" under the Investment Company Act of 1940 but for the exceptions in Section 3(c)(1) or 3(c)(7) thereof. The rule defines an "ownership interest" in a covered fund to mean any equity, partnership or "other similar interest." Many CLOs rely on the 3(c)(7) exception and would be "covered funds" under the Volcker Rule absent an exemption or exclusion. Banking entities generally interpret "other similar interest" to include senior CLO notes because their holders generally have rights to remove or replace the CLO manager, which was a feature described in the 2013 Rules as one indicative of an "other similar interest."

The 2013 Rules created a loan securitization exclusion (the "**LSE**") from the definition of "covered fund" for CLOs comprised solely of loans, servicing rights and other assets incidental to loan ownership. Many CLOs created after implementation of the 2013 Rules have relied on the LSE and have therefore been restricted from purchasing non-loan assets.

The Modified Rule provides banking entities with incremental relief from the Volcker Rule's prohibitions on investments in CLO securities by (i) introducing a 5% bucket for certain debt securities under the LSE, (ii) providing a safe harbor for certain senior debt interests to not constitute "ownership interests" under the rule and (iii) clarifying that the rights of a CLO investor to participate in the for-cause removal or replacement of a CLO manager for certain enumerated "cause" event triggers are creditor rights that do not on their own give rise to an "ownership interest".

[1] "Agencies" refers to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission.

COMMONLY ASKED QUESTIONS ABOUT THE MODIFIED RULE

1. *When will the Modified Rule take effect?*

   The Modified Rule will become effective on October 1, 2020.

2. *Will CLOs be able to invest in bonds?*

   Two aspects of the Modified Rule are helpful here. Firstly, it permits CLOs relying on the LSE to hold up to 5% of their assets in debt securities, excluding asset-backed securities and convertible securities. Secondly, the Modified Rule provides banking entities independent relief from the Volcker Rule's prohibition on investing in "ownership interests" of covered funds through the introduction of a new safe harbor that carves out at least some senior CLO securities from the definition of "ownership interest" for this purpose.

   Existing CLOs with indentures that do not expressly permit investment in bonds, whether currently or through a "springing bond bucket"—a feature that permits investment in debt securities at such future time and to the extent the Volcker Rule is either amended or interpreted by regulators to allow it—will not be permitted to take advantage of this new flexibility without entering into a supplemental indenture, which in most cases will require the consent of holders of one or more classes of notes.

   As for new CLOs, investors will determine whether to permit inclusion of a bond bucket, a decision that could well be driven by how experienced the collateral manager's team is perceived to be in investing in such securities.

3. *How is the 5% calculated?*

   This 5% limit is generally par value-based, calculated at the most recent time of acquisition of each such debt security, and must not exceed 5% of the aggregate value of all loans, other debt securities, cash and cash equivalents held by the CLO. [2] The value of a purchased debt security (and the CLO's loans, cash equivalents and other debt securities constituting the denominator in the calculation) may be based on fair market value, however, if "(1) the issuing entity is required to use the fair market value of such loan or debt security for purposes of calculating compliance with concentration limitations or other similar calculations under its transaction agreements and (2) the issuing entity's valuation methodology values similarly situated assets, for example non-performing loans, consistently."[3]

4. *What are the requirements for the safe harbor?*

   The new safe harbor provides that an "ownership interest" does not include "[a]ny senior loan or senior debt interest that has the following characteristics:

   (*1*) Under the terms of the interest the holders of such interest do not have the right to receive a share of the income, gains, or profits of the covered fund, but are entitled to receive only: (*i*) Interest at a stated interest rate, as well as commitment fees or other fees, which are not determined by reference to the performance of the underlying assets of the covered fund; and (*ii*) Repayment of a fixed principal amount, on or before a maturity date, in a contractually-determined manner (which may include prepayment premiums intended solely to reflect, and compensate holders of the interest for, forgone income resulting from an early prepayment);

   (*2*) The entitlement to payments under the terms of the interest are absolute and could not be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest; and

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[2] See Preamble at 45-46.

[3] Preamble at 47.

(*3*) The holders of the interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)."[4]

Market participants had requested of the Agencies certain other clarifications, including that the exposures that would benefit from the safe harbor include all "investment grade" tranches. In staying faithful to a principles-based approach, however, the Agencies stated they believe the final safe harbor, which does not include such a clarification, "will provide additional clarity that the safe harbor is available to senior loan and senior debt interests where contractual principal payments vary over the life of a senior loan or senior debt interest for reasons such as amortization and acceleration provided that the total amount of principal required to be repaid over the life of the instrument does not change."[5] Similarly, the Agencies rejected other securitization-specific clarifying proposals in favor of the above approach, which they stated would "clarify that a debt interest in a covered fund would not be considered an ownership interest solely because the interest is entitled to receive an allocation of collections from the covered fund's underlying financial assets in accordance with a contractual priority of payments."[6] Because typical CLO indentures confer on holders of the most senior class of notes rights that do not extend beyond those described in the final safe harbor, it seems clear the Agencies intended for the safe harbor to cover them.

5. What are the implications for CLOs investing in securities other than bonds?

Investors will determine how much flexibility, if any, to provide to collateral managers in light of the Modified Rule's new safe harbor. Now that CLOs need not be structured consistent with the LSE requirements in order for their senior debt securities to constitute permissible investments for banks, it is possible for CLO indentures to permit certain other investments in non-loan assets without sacrificing a significant portion of their investor base. One category of investments—even if structured to consist of a relatively modest amount of a CLO's aggregate assets—that could be particularly useful for CLO managers as we move further into part of an economic cycle that portends increasing amounts of borrower defaults would be "new money" purchases of assets offered to creditors' committees in a restructuring context. Currently, even though CLOs collectively represent a large and growing segment of broadly syndicated leveraged loans, they are largely constrained in their ability to participate in offerings of warrants and other equity securities in which other debt investors can invest as a means of protecting an existing term loan investment or participating in potential upside beyond such initial loan investments.

6. What is the import of the "ownership interest" clarification concerning creditors' rights?

This clarification puts to rest the concern that banking entities previously had that the rights they have as investors in senior CLO notes to remove or replace the CLO manager for certain "cause" events give rise to an "ownership interest." The Modified Rule clarifies that these are customary creditor rights even though they may not be included in CLO documentation as rights arising under events of default or acceleration scenarios.[7] The "for cause" events listed in the Modified Rule are:

1. bankruptcy of investment manager;
2. breach by investment manager of material provisions of transaction agreements;
3. fraud or criminal activity in the performance of investment manager's obligations;
4. indictment of investment manager (or personnel) for criminal offense materially related to investment management activities;
5. change in control of investment manager;
6. key person event; and

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[4] Modified Rule § __.10(d)(6)(ii)(B).

[5] Preamble at 153-154.

[6] Preamble at 155.

[7] Preamble at 150.

7. other similar events that constitute “cause” for removal provided that such events are not solely related to the performance of the covered fund or to the investment manager’s exercise of investment discretion.[8]

CONCLUSION

The Modified Rule presents interesting opportunities for CLO structurers and managers to explore with potential investors new features that could provide CLOs with additional flexibility to invest in bonds and other non-loan assets. As ever, this market will remain an interesting space to watch as a result.

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[8] Preamble at 151-152.

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